PN-ACA-931
103026

USAID Evaluation Special Study Report No 82

Enterprise Funds
A New Development Tool?

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Center for Development Information and Evaluation
U S Agency for International Development

October 1999

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Summary

With the end of the Cold War, the United States was presented with a novel development challenge helping former Soviet-bloc nations move from a centrally planned economy to a market economy Addressing this task, President Bush proposed a new concept, enterprise funds—nonprofit corporations that would use a U S government grant to make equity investments and loans to medium-size and small enterprises The funds would be managed by private individuals with extensive business or country experience They would seek to stimulate the growth of the private sector in a specific country or region

Four enterprise funds, all in eastern Europe, have been operating for more than seven years One, the Polish fund, has been an enormous success, while the performance of a second has been awful A third, following serious conflict with the U S government, seems bound for modest success while the fourth made rapid progress in finding suitable investments only in its sixth and seventh years of operation Despite this mixed record, the early funds probably played a key role in the early days of the transition from communism to market economies They demonstrated U S support for private sector development and in the Polish case, helped shape that transition They also made many good investments in emerging companies and helped them grow And they helped catalyze the interest of private investors in eastern Europe

Seven other enterprise funds are newer with between four and five years of operation and so provide a more limited base on which to judge their eventual success The newer funds have uniformly been much slower in making investments than the early funds, so most of their results are still in the future In their first 42 months of operation the eight newest funds disbursed only 24 percent of their capital for investments, compared with 60 percent for the first three funds during an equivalent period The newer funds also have found the costs of operation to be much higher than did the early funds

This slower start appears to be due to two factors First, country conditions are much more difficult in these later countries, with weaker macroeconomic policies and a much less developed institutional base for the growth of the private sector The transition to a vibrant market economy is likely to take much longer and be more subject to government policy reversals than in Poland, Hungary and the Czech and Slovak Republics Second, private investors have begun to make massive investments in the countries of the former Soviet bloc This provides substantially increased competition for the best deals It also obviates one original rational for enterprise funds that of catalyst for private investment

Enterprise funds began as an ad hoc response to the specific situation posed in 1989 by the impending transition to market economies by Hungary and Poland They have subsequently been used to promote the private sector in quite different circumstances This has moved funds from a situation in which they were a creative and potentially highly effective tool to one in which they have found greater difficulties finding a proper niche It has also raised the question of whether enterprise funds have an incentive structure appropriate to the longer term problems that they now face

The newer enterprise funds may find a useful niche as they acquire experience and disburse their resources, but their contribution to economic development will come more slowly Although enterprise funds have concentrated on financing the growth of a limited number of individual enterprises, the justification for use of public funds has lain in the catalytic effect this will have on the overall country environment for business Judging by experience to date the newer funds have substantially smaller prospects for catalytic effects on other investment or on the economic climate than the first funds

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The Enterprise Fund Experience

This Special Study examines the experience of the 11 existing enterprise funds to determine whether this approach is a useful tool for future USAID programs in developing countries It is not an evaluation of those funds, rather it is a limited review of the available evidence—primarily reports by the individual enterprise funds of their activities, supplemented by interviews with fund principals and review of U S government and public records about their operation An evaluation of how the funds have performed would necessarily include analysis of their impact on the individual enterprises they have financed, as well as extensive in-country work to identify other results of enterprise fund operations

We seek here an answer to a straightforward question Does the enterprise fund experience to date suggest that USAID should use this tool in additional countries? On the basis of the evidence presented here, the answer is a qualified no The stunning success of the first fund, in Poland, is not being repeated in any other country, and the results being produced by newer funds are too inconclusive to warrant creation of additional funds at the present time This conclusion cannot be definitive, for most of the funds are still in an early stage of their development Another review of the validity of this conclusion might be appropriate two years into the future, after further evidence of the success or failure of the existing enterprise funds has accumulated

The Concept

"Enterprise funds" were first proposed by President Bush in speeches in Warsaw and Budapest in June 1989 At the time the future of Eastern Europe seemed to hang in the balance The Berlin Wall was not to fall until five months later, but the sense of impending change was evident The announcement was intended to demonstrate U S government backing for the conversion of these countries into market economies by supporting their nascent private sectors

The enterprise fund concept was defined only in very broad terms at the time, but State Department and USAID officials worked in subsequent months to give it texture By September, a concept paper had given clear shape to the proposal * That paper identifies growth of medium-size and small businesses as critical to the

Concept Paper, The Polish–American Enterprise Fund The Hungarian American Enterprise Fund Undated (September 1989) rapid emergence of a dynamic private sector It concludes that there is a need to channel investment resources to such firms The paper proposes the creation of nonprofit corporations, managed by private individuals with extensive business or country experience, that would use a U S government grant to make investments in promising private businesses in the two countries The board of directors would use its collective judgment about what kinds of activities to undertake, though this was generally assumed to include equity investments and loans to business firms and investment in financial intermediaries To buttress their investment role, enterprise funds would also have funds to encourage other activities relevant to the creation of a market economy They might also give advice to governments on these issues

The concept paper emphasized the advantages of using private sector decision-making in the rapidly evolving economic climates of Poland and Hungary It also anticipated that the funds would operate under U S government policy guidance and work closely with other U S assistance programs These expectations were not codified in legislation or the subsequent USAID grant agreements The prevailing view at that time within the administration held that an outside organization would act faster and more effectively than a program operated directly through USAID, which was seen as slow to act and bureaucratic in its procedures The enterprise funds were seen as a way to avoid such problems

President Bush proposed legislation for this purpose in September 1989, and the Support for East European Democracy (SEED) Act (PL 101-179) of November 1989 specifically authorized the establishment of enterprise funds for Poland and Hungary Both funds were to be private nonprofit corporations Congress authorized $240 million in U S government funding for the Polish fund and $60 million for the Hungarian fund Each fund was to be governed by a board of directors made up of a majority of U S citizens from the private sector with relevant experience, and by private nationals of the assisted country The funds aimed to 1) develop the Polish and Hungarian private sectors, including small businesses agriculture and joint ventures with U S and host country participants, and 2) develop policies and practices conducive to private sector development in Poland and Hungary, through loans grants, equity investments, feasibility studies technical assistance training, insurance, guarantees and other measures *

Beyond this general purpose and the composition of the board of directors, the law is virtually silent on structure or mode of operation The law requires only a series of procedural actions that the funds maintain adequate records, that they undergo annual independent audits by a private accounting firm, that they publish a comprehensive annual report that they accept audits by the General Accounting Office, and that payments from the enterprise fund to employees of the fund be limited to "salary and reasonable compensation for services " This compensation was limited, initially informally and later in specific agreements with the U S government to a maximum of $150,000 per year for any employee of a fund or subsidiary

Funds were expected to operate for a limited period expected informally to be 10 to 15 years during which the country s transition to a market economy would be completed At the end of this time, the fund s assets would be sold hopefully into vibrant capital markets in the assisted countries, and proceeds returned to the U S government

From this initial conception, the enterprise funds that have been created all share five characteristics They involve a *U S government grant* made to an *unpaid presidentially appointed*

* SEED Act (PL 101–179) section 201

board of directors which has substantial *independence* in choosing an investment strategy for an *expected life of 10–15 years* with *compensation of employees capped* at $150,000 a year For the purpose of this Special Study, these five characteristics define what an enterprise fund is

Putting Enterprise Funds Into Operation

In the seven years since the SEED Act was passed, the U S government has established a total of 13 enterprise funds One, the Defense Conversion fund, has been managed by the Defense Department and is not included here Two Russian funds were merged in 1995, leaving a total of 11 funds reviewed in this study Those 11 funds have an authorized capital of $1 4 billion, of which USAID has disbursed $550 million All but one (the Southern Africa Enterprise Development Fund) operate in countries of the former Soviet bloc Existing funds now cover all of the countries in the bloc except the former Yugoslavia and those in the southern Caucasus An enterprise fund in the latter region is expected to be established in 1997

The White House named initial boards of directors of the Polish and Hungarian enterprise funds in February 1990 and the boards developed rules for operation and general approaches Both funds were incorporated in April 1990 and received initial grants from USAID in May The funds adopted a policy, emulated by all subsequent funds, that the board of directors would serve without compensation Thus, all the enterprise funds have relied on unpaid volunteer work—sometimes very extensive—by their boards Both initial funds also decided to create internal management structures rather than contract out the operation of the fund *

The two funds shortly afterward established offices in the United States and in the recipient country, and began hiring staff The time required for this process led to the first uneasiness that the funds were moving too slowly A congressional committee complained in October 1990, 10 months after the legislation was approved and 6 months after the first two funds were incorporated that

> The Committee is concerned with the lengthy delay in beginning operations of the Polish-American and Hungarian-American enterprise funds Nearly 1 year has passed since Congress approved the President s request to establish these funds as a primary source of United States assistance to emerging private sectors in Hungary and Poland The record of activity is as yet too sparse for the Committee to draw any conclusions about the effectiveness of the enterprise funds and about whether they represent any model for how U S assistance could be channeled to other Eastern European countries †

In response to complaints that USAID was attempting to supervise the operation of the funds, the same report reiterated the congressional intent that the funds were to be operationally independent It stated that USAID's role was "simply to write the check on a periodic basis when the enterprise funds determine that additional funding is necessary "

Despite the perception of slowness to make investments, the initial response to creation of the first two funds was positive enough to lead the government to establish two additional funds in 1991—the Czech–Slovak Fund in March and the Bulgarian Fund in November While the Czech and Slovak Republics were similar to Po-

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*To speed up fund activity, USAID had issued a call for proposals for management of enterprise funds using general terms of reference before the funds were formally created The proposals received were provided to the fund boards when they were constituted In both cases, the fund board decided to hire its own management staff Use of management contracts was seen as too expensive and not likely to provide the country expertise required

†U S Senate Report 101–519 p 111

land and Hungary in economic structure, Bulgaria was a more speculative venture, though hopes were high in the State Department that it could quickly follow those countries in moving toward a market economy In announcing the Bulgarian Fund, Lawrence Eagleburger then deputy secretary of state, characterized Bulgaria as "the best-kept secret in Europe"

There was then a hiatus of more than two years Governments in other former Soviet-bloc countries expressed interest in enterprise funds as a U S government endorsement for private enterprise development USAID did some planning for new funds, but the Clinton administration was initially skeptical of their desirability The creation of additional funds had considerable support from the State Department, notably from American ambassadors in the region The latter saw funds as a tool for promoting American investment and demonstrating U S support for the move to a market economy The decision to start a Russian fund was made in September 1993 This was followed by a second Russian fund for large enterprises in February 1994, by four additional funds in the summer of 1994, and two more in February 1995, including one for Southern Africa—the first and only fund outside the former Soviet bloc

Case studies of each of the 11 funds were prepared for this study Each provides a history of the fund s activities and the approaches it has used These are summarized in table 1 and in the appendix More briefly, a capsulized summary of each fund's activities follows in chronological order of the fund's incorporation

The **Polish–American Enterprise Fund** (1990 ultimately $264 million) has built a successful portfolio that should return a profit to the U S government The fund raised $250 million in private money, created Poland's first mortgage bank, and established a successful and widely emulated small-loan program The fund was a highly visible presence in Poland, particularly during the period 1991–93 before significant private foreign investment began to flow into the country Its board included members of the U S financial community but also former national security adviser Zbigniew Brzezinski, and AFL–CIO president Lane Kirkland, both of whom had been active for more than a decade in promoting Poland's separation from the Soviet bloc Polish members of the board were major figures including a subsequent prime minister and a former finance minister It stopped making new investments in early 1997 and has begun discussions with the U S government for its dissolution

The **Hungarian–American Enterprise Fund** (1990 $70 million) began at the same time as the Polish fund Its original board sought to make the fund a major player in the Hungarian financial community Like the Polish fund, it began making investments quickly It appeared to be on track to be fully invested by the end of 1993 But the fund's activities were, in effect, suspended for nearly a year in 1993 because of a major conflict with the U S government The fund established a merchant banking subsidiary in 1992 as a means to promote investment in Hungary When details of the financial commitments to the merchant banking principals became public in 1993 U S government disbursements were held up Fund management was eventually changed, and the fund later resumed operations Hungary has attracted large amounts of foreign investment, and the fund has since become a respected, though small player in the Hungarian financial community The fund raised $50 million in private money in 1997 It may return a profit to the U S government

The **Czech–Slovak American Enterprise Fund** (1991, $65 million) took a more explicitly developmental approach than either of the two earlier funds seeking investments in startup firms and firms in smaller towns and high-unemployment areas In-country staff had little financial experience and the board chairman's dominance of decision-making led to high staff turnover This sharpened the problems of managing a high-risk portfolio Following a period of con-

Table 1. Summary of USAID-Supported Enterprise Funds

Enterprise Fund	Incorporation Date	Approved Funding ($ m)	USAID Disbursements	Basic Tools	Country Conditions
Polish	April 1990	$264	fully committed	equity, small loans strategic investing	good
Hungarian	April 1990	$70	fully committed	equity	good
Czech–Slovak	March 1991	$65	$46	equity and loans	good
Bulgarian	November 1991	$55	$31	equity and small loan	poor
Russian	September 1993	$340			
Fund for Large Enterprise Restructuring	February 1994	$100			
U S –Russia	May 1995 from merger of RAEF and FLER	$440	$102	equity, loans	mixed
Baltic Romanian	July 1994 July 1994	$50 $50	$15 $16	loans equity	good mixed
Central Asian	July 1994	$150	$53	equity, small loan	mixed
Western NIS	August 1994	$150	$28	equity, small loans	poor
Albanian	February 1995	$30	$4	equity loans	poor
Southern Africa	February 1995	$108	$2	loans, equity	good

flict within the board of directors a small scandal led to replacement of the chairman The U S government subsequently asked the entire board to resign After the U S government named a new board in 1996 the fund sold its Czech portfolio for only 10 cents on the dollar It concentrated its remaining assets in the Slovak Republic

Some have used the poor performance of this fund to suggest closer U S government oversight for enterprise funds This fund consulted more with USAID officials and provided considerably more information on each of its operations than either of the two earlier funds, so lack of oversight was not the major issue It was only in 1994, after management problems had continued to persist, that the U S government began to show concern By that time, most of the poor investments had already been made

The **Bulgarian–American Enterprise Fund** (1991, $55 million) has disbursed only about 60 percent of its authorized capital in five years of operation, so any assessment of its success is still premature This fund had early losses on its first two projects, both joint ventures and has since experimented with a variety of approaches None of these has yet been obviously successful, and the fund has created substantial reserves against losses in the portfolio Optimism about the Bulgarian economy evident at the creation of the fund has proven unfounded Economic reforms expected with the collapse of communism did not occur and the country drifted for several years A severe economic and political crisis led to a change in government in early 1997 With the change the fund was again hopeful of making new investments

The **U S –Russian Investment Fund** (1995, $440 million) came from the merger in 1995 of two funds established in 1993 and 1994 These were the Russian–American Enterprise Fund and the Fund for Large Enterprise Restructuring The fund established an extensive network of offices and has begun a variety of activities Its operating costs have been high, investment activity slow More than 3½ years after the first Russian fund was created, disbursements for investments are only 15 percent of its capital

The **Baltic–American Enterprise Fund** (1994 $50 million) concluded that the up-front costs of developing an equity portfolio would be too high The fund chose to specialize in small loans (average of $100 000) in the three Baltic republics (Estonia, Latvia, and Lithuania), seeking to minimize operating costs by standardizing its product By May 1997 it had disbursed $8 8 million

The **Romanian–American Enterprise Fund** (1994, $50 million) made seven investments for $5 8 million by the end of 1996 and also committed $5 million to a small-loan program It faced serious problems with country conditions and there were major conflicts within the board of directors, with both the president and chairman resigning By early 1997 country conditions had improved, and internal conflicts had abated In May 1997, the fund reached agreement with an Austrian investor to sell half its $8 million investment portfolio and to cofinance all future investments on a 50–50 basis This should ultimately provide about $17 million in private funds

The **Central Asian–American Enterprise Fund** (1994 $150 million) operates in five Central Asian countries, though most of its activity has been in two—Uzbekistan and Kazakstan It has moved more rapidly than any of the other new funds By June 1997 it had committed $46 million (and disbursed $31 million) in 24 investments It also had committed $10 million to a small-loan subsidiary, disbursing $4 5 million to 68 borrowers Uzbek policy action in 1996 ending currency convertibility curtailed investment there

The **Western Newly Independent States Enterprise Fund** (1994 $150 million) operates in Ukraine, Belarus, and Moldova, though nearly all of its activity so far has been in Ukraine By the end of 1996 it had made commitments on 18 investments for $26 million, and it had opened a bank for small-lending operations

The **Albanian–American Enterprise Fund** (1995 $30 million) is the smallest fund It operated for only about one year when civil disturbances led to the evacuation of the American Embassy and the fund's Albanian manager It had disbursed about $2 5 million in investments With the return of civil order the fund is considering establishing a bank

The **Southern African–American Enterprise Development Fund** (1995, $108 million) began with a more explicit developmental mandate and with a closer tie to USAID which has a nonvoting member on its board of directors The board, now 18 members strong, had difficulty coming to final agreement on approach and on selection of management staff The fund made its first disbursement in June 1997

Activities of The Enterprise Funds

All the enterprise funds have identified financing to medium-size enterprises as their main goal Through 1997 the enterprise funds had invested about $500 million in some 250 firms Two thirds of their investments were in equity With the exception of the Baltic fund every fund has preferred equity investment over loans Investments have averaged about $2 million overall, but the average for individual funds varies from $400,000 to $3 million Funds with larger initial capitalizations have preferred larger deals The funds have typically sought to build up a portfolio of 30–50 investments in companies with growth potential Funds usually have taken minority equity positions but most were willing to take majority positions to improve prospects for the company

Once an enterprise fund invests in a company it typically requires the firm to upgrade its financial management by improving its accounting and management information systems, and typically the fund acquires a seat on the company s board of directors The expectation is that the enterprise fund will oversee expansion of the company in line with business plans developed jointly, and will sell its holdings after 3–5 years

Enterprise funds have also engaged in three other significant activities

Small- and micro-loan programs Most funds have also established small-loan programs (typically $20 000 to $100,000), or micro loan programs ($1 000 to $20,000) In most cases, the fund have used existing banks as the vehicle for these programs usually providing technical assistance to the bank on the design of the new program In Poland the small-loan program was a major success making more than 5 000 loans for $175 million by the end of 1996 The low delinquency rate on these loans—below 2 percent—identified an underserved but profitable market, leading to emulation by Polish banks A microloan program launched in 1995 by the Polish fund also shows promise However, none of the small-lending programs initiated by other funds has yet shown the promise of similar success The Polish fund accounts for more than two thirds of the number of small and micro borrowers of all the funds Most funds have treated this activity as a sideline responsive to USAID's interest in small and micro enterprises

Technical assistance The early funds were encouraged to provide technical assistance to promote transition to a market economy The Polish fund was provided an additional $15 million for this purpose, and the Hungarian fund $5 million The funds undertook a variety of small activities, ranging from information packages on the operations of a market economy to management training for businessmen One such activity—supplementing the salary of a Hungarian government official—led to adverse publicity and to a conclusion by the U S government that technical assistance should be circumscribed to activities related to the funds' investments Subsequent activities typically included assistance in establishing accounting and management information systems Eventually the U S government ceased providing separate funding for such activities Those funds without separate funding for technical assistance have spent little for such purposes

Raising private capital Enterprise funds were expected to attempt to raise private capital to supplement their own efforts with U S government resources Most funds have expressed an intention to do so Private capital provides important benefits to the fund It allows the fund to spread its overhead costs over a larger investment pool and to market its country and enterprise expertise Potentially more important, private capital allows a means to compensate senior fund managers for successful investments In the private sector, this is typically done through a share in the profits of a venture fund Such profit-sharing is not possible with the capital provided by the U S government, and compensation to employees is limited to $150,000 per year

So far, only three funds have actually raised private capital the two original funds in Poland and Hungary and the Romania fund The Poland fund has done so twice, in 1992 and 1997, raising a total of $250 million The Hungarian fund raised $30 million and the Romanian fund an amount likely to be about $17 million For the most part, private investors have not seen enterprise funds as a necessary intermediary for investment Many private venture capital funds have begun operating in the region, and multilateral institutions (notably the European Bank for Reconstruction and Development and International Finance Corporation) have promoted others All told, the total flow of private investment to the region has grown dramatically over the past five years

Expectations and Results

When the enterprise fund concept was first introduced there were many things that the designers believed they might achieve Given the unknowns about the transition from communism many possible results were plausible Possible areas where funds might make key contributions included promotion of joint ventures with U S companies, a role in privatization and as a way of providing a more flexible response to the problems of economic transition from communism The available evidence on what enterprise funds have done in various possible roles is discussed below

Enterprise Funds as Promoters Of Joint Ventures

Some expected at the outset that enterprise funds would catalyze joint ventures between American firms and host country enterprises Indeed, some of the early funds saw the U S office as a vehicle for such investments Early experiences of the Hungarian and Czech–Slovak funds with joint ventures encouraged by the U S office were unsatisfactory, and later funds used their host country office as the locus for investment activity

Joint ventures also have produced mixed results The Bulgarian fund had major problems with its first two investments, both of which were joint ventures and the Russian fund had a major failure in a joint venture with a U S company Some smaller joint ventures succeeded, but promotion of joint ventures is not a major feature of the current investment strategy of any of the enterprise funds All the funds see domestic enterprises as their main target group and use the host country office for identifying and reviewing investment proposals

Involving American Entrepreneurs

An expected though unquantifiable result of the enterprise fund program is to enlist the involvement of successful American businessmen in economic development problems This primarily occurs with boards of directors who serve without compensation in all the funds Many members of these boards have taken a major interest, and committed substantial amounts of time, to the problem of promoting economic growth through enterprise development Nevertheless, as discussed below, there has been an enormous increase in interest by American entrepreneurs and others in investment in the transition economies that has been taking place without U S government involvement

Enterprise funds and Privatization

The managers of several early funds expected a large and steady "deal flow" to come from privatization, as governments divested themselves of state-owned enterprises The privatization process has been slower, more political, and more complex than the early expectations, and each country has followed a different path to divestment While some funds, most notably in Poland have participated creatively in this, it has been of marginal consequence to the investment flow of most of the funds Privatization has done little for the funds, and the funds have done little—because of the highly political nature of that process—to affect the pace or structure of privatization

Enterprise Funds And Stock Market Development

In the more advanced countries, as was hoped, enterprise funds have helped significant numbers of companies develop the capacity and financial strength to go public and have helped improve the climate for publicly held companies Nevertheless, the development of stock markets will depend much more on factors outside the scope of operations of enterprise funds, including privatization of state enterprises much larger than those assisted by the funds

Training Capital Market Professionals

Most enterprise funds have been effective in training a group of nationals in American techniques for investment analysis Several of the early funds seem on the way to leaving behind viable institutions that can serve the respective countries' financial markets as the develop further, even after the enterprise fund repays its grant to the U S government

Flexibility Of Enterprise Funds

Part of the initial rationale for enterprise funds was the belief that they would identify opportunities and adapt to the rapidly changing circumstances of transition from communism and to the test of the marketplace faster and more flexibly than direct USAID-managed projects This view was amply justified in Poland where the fund moved quickly into a variety of activities including banking mortgage finance and small loans

The Hungarian fund's creation of a merchant banking subsidiary was a less felicitous example of flexibility Its arrangements were seen by congressional leaders as a violation of the spirit of the informal agreements on financial compensation This case was seen as evidence of funds having too much flexibility The U S government subsequently established and has subsequently steadily increased, the amount of oversight and control imposed on the funds

In Bulgaria the enterprise fund also tested a wide variety of instruments and approaches—small and micro loans, sector programs for agribusiness, hotels, and dairies—and has recently returned to a primary emphasis on large individual investments The outcome differed from that in Poland in that none of the approaches tested seems to have been particularly successful The fund continues to look for a productive niche

The poor performance of the Bulgarian economy—in contrast to the quick turnaround in Poland—probably best explains the fund's problems Nevertheless, it suggests a sense in which enterprise funds, as a hybrid between institutions both public and private may be less flexible than either A private venture-capital fund might have chosen to invest in Bulgaria, but the very mixed experience of such a fund's first several years of operation would surely have led it to conclude that the time and place were not ripe It would have redeployed its capital and management time elsewhere Similarly, a USAID project, faced with very modest results to show for five years of effort, would likely have been closed down Enterprise funds, however, are given a fixed country mandate and an expected time horizon of 10 to 15 years There is no turning back after the initial startup

In general, benefits from flexibility of response have been less evident in the more recent funds None has so far found any rich unmined veins similar to the small-lending vehicle of the Polish fund Nor have any of the newer funds yet attempted a major financial innovation, like the Polish fund's mortgage bank More broadly, the base of knowledge about economic transition from both analytical work and practical experience, has increased enormously since 1989 when it involved stepping into the unknown In recognition of this donor assistance programs should today be adapted accordingly with narrower purposes and more clearly defined goals

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Lessons From The Fund Experience

By their nature enterprise funds are slow-maturing activities There is a long gestation period before significant results positive or negative will emerge * At best, experience has shown that at least six months will elapse between the legal institution of a fund and the beginning of its investment activity From there a minimum of three years is needed to commit the fund's resources with disbursements lagging somewhat behind commitments Investments in the third year are likely to be significantly better than the early ones, as each fund has learned from experience all the problems that arise from operating in a new, changing, difficult environment

Once investments are made companies that are good bets will gradually increase their sales and profits, with demonstrated success emerging over several years Bad investments, by contrast, begin to emerge quickly, as firms unable to pay their bills stop operating Consequently a time lapse of five to eight years is typically required to demonstrate the success or failure of an enterprise fund In the meantime, results of fund investment are likely to be misleading The most conspicuously successful of the enterprise funds the Polish fund showed five years of losses on its portfolio before first showing a net gain in its 1996 annual report

This basic characteristic has created serious problems for U S government oversight of enterprise funds and for decision-making regarding the creation of new funds Prodded by circumstances (the enthusiasm of ambassadors for a fund in each country as a demonstration of U S government support for transition and of host governments anxious for additional foreign investment) new funds were created long before a reasonable judgment on their ultimate efficacy could be formed

The First Four Funds

Preliminary judgments about overall impact are possible at this juncture only for the four oldest funds, established in 1990 and 1991 All have been operating for more than seven years The two Russian funds were established in late

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The length of the gestation period does not necessarily correlate with effectiveness For example, primary education is generally considered a critical determinant of economic development yet it is an investment that does not begin to pay off until children enter the labor force a decade or more after the initial investment in their education begins

1993 and early 1994 They thus have more than five years of operating experience, though less than four as a combined operation The other six funds have existed for between four and five years It is early in the life of these funds to assess performance What *can* be assessed is what the funds have attempted to do and the problems that have emerged as they did so

The first four funds have each invested the majority of their capital Their fortunes cover the spectrum one enormous success, one clear failure, one spoiled experiment and one incomplete

The Polish–American Enterprise Fund played a major and perhaps critical role in Poland's transition to a market economy It was the right instrument, managed by the right people, in the right place, at the right time Its close connection to the country's political leadership at the time that the pace and direction of economic reform were still being debated provided support for faster reform

The Hungarian–American Enterprise Fund also may have played an important role early, but several factors make its ultimate significance much smaller First, though the fund may have been a key player in signaling U S government support for Hungarian transition its quantitative relevance to the transition was soon swamped by more than $5 billion in private investment flows during 1991–93 Second, conflict with the U S government in 1993 over the fund's approach to creation of a merchant-banking subsidiary led to virtual suspension of fund activity for a year and to the replacement of the fund's chief executive officer By the end of the hiatus, the fund was a relatively small actor in a booming investment environment What role the fund would have played in the absence of the conflict with the U S government has to be conjectural

The Czech–Slovak Fund the failed experiment made a serious effort to identify good investments It took more risks than the other early funds It also made poorer choices for management staff, relying on people with considerably less experience, and frequently replacing senior managers The consequence was a poor portfolio whose performance deteriorated even more when conflicts with the U S government led to long periods without strong management The experience serves to underscore the observation that equity investment is a very difficult business, and success depends on having high-quality professional staff

The Bulgarian–American Enterprise Fund is the incomplete experiment Unlike what happened in Poland, Hungary and the Czech and Slovak Republics, the country environment did not rapidly improve The fund tried a variety of approaches and activities, but none has so far yielded major positive results Because of its slowness to invest, it has more in common with the later funds than with the first three and is therefore grouped with them

Pace of Investment

For enterprise funds investments are the primary vehicle for achieving impact The initial expectation was that enterprise funds would commit their capital over about three years This has proven unrealistic While the first three funds found suitable investments relatively quickly, the remaining funds all moved much more slowly at least initially Since most of the funds are still relatively young it is still uncertain whether the pace will speed up Data are available for all 11 funds for their first 42 months after incorporation (see table 2) The eight most recent funds all began investing at a considerably slower pace than any of the first three funds the quickest starting of the newer funds the Central Asian fund disbursed 30 percent of its capital in the first three years, compared with 45 percent for the Czech–Slovak fund, the slowest of the early funds Altogether the first three funds disbursed 60 percent of their capital in the first 3½ years of operation compared with only 24 percent for the 8 newer funds

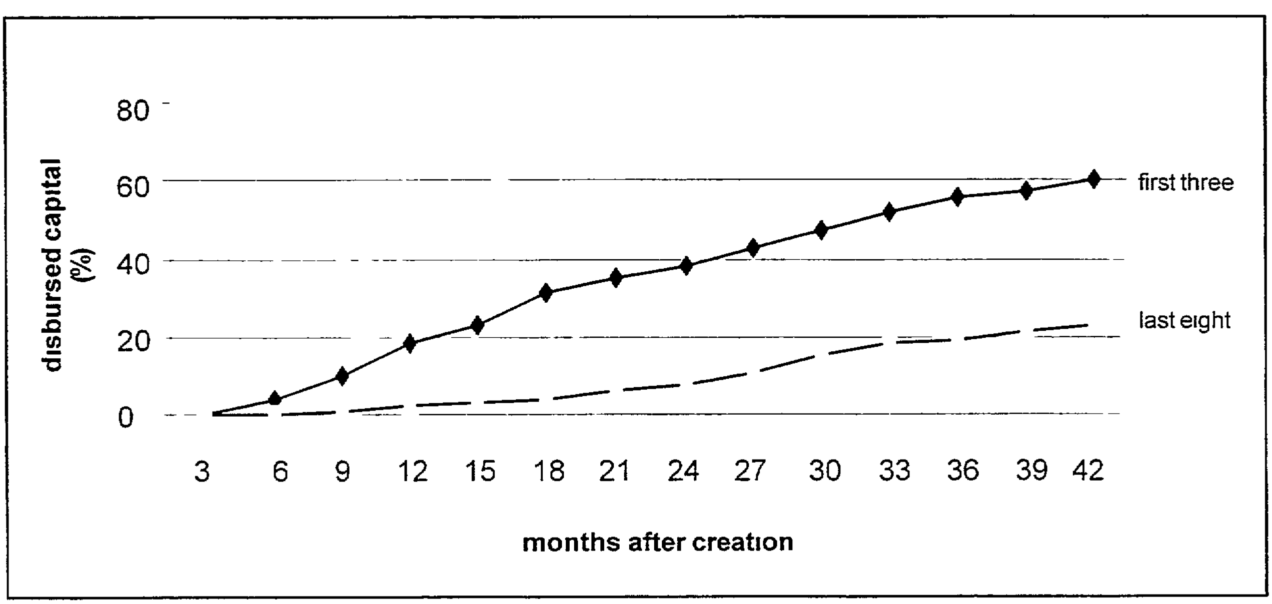
Table 2. Comparative Performance During First 42 Months of Operation

Enterprise Fund	Investments as % of Capital
Polish	59
Hungarian	74
Czech–Slovak	50
Total, first three funds	**60**
Bulgarian	16
Russian	13
Baltic	42
Romanian	45
Central Asian	47
Western NIS	29
Albanian	58
Southern Africa	8
Total, last eight funds	**24**

The striking difference in performance for the two groups is shown graphically in figure 1 At first sight, the slower start by newer funds is counter to expectations Other things being equal, one would have expected later funds to have started faster They had the experience of the first funds to draw on in a variety of ways such as legal organization, mechanisms for structuring the organization and relationships with the U S government The collapse of communism was more evident and certain by the time the later funds began

All the newer enterprise funds have been operating for at least 42 months All but two were at least

Figure 1 Enterprise Funds



34 months old In a much shorter period—30 months—the Polish fund had

- Disbursed $66 million on investment programs, with an additional $126 million in commitments
- Set up small loan program disbursing $33 million to 1,430 borrowers
- Bought a private bank
- Raised $100 million in outside capital
- Established the country's first private mortgage bank

Nothing remotely similar is yet evident in any of the newer funds

That the eight newer funds were uniformly slow in starting up suggests strongly that the difficulties trace mainly to common problems rather than to individual fund managements After all, each fund is managed by a different group of individuals with extensive business experience It is to be expected that the experimentation and diversity of approach would lead some funds in a more promising direction than others

Two common factors suggest themselves as explanations First, the economic climate in the latter eight countries is distinctly less favorable than that of the first three Macroeconomic policy is less propitious, the legal and regulatory environment is less developed A working paper for this study compared the economic environments in the countries with enterprise funds * Going by the available data, the author classified only Poland Hungary, the Czech and Slovak Republics, Latvia and Estonia as market economies All the other former communist countries were seen to be at an earlier state in both economic policies and institutions Second the funds have more competition from private investors, and so, unlike the first enterprise funds, they lack easy access to the most promising investments This point is developed further below

Enterprise funds were seen not just as competent investors in 40 or so ventures in a country but also as catalysts for the creation of a dynamic private sector Congress approved creation of the first funds in 1989 three weeks after the Berlin Wall had fallen and the future of Eastern Europe was still speculative Events moved quickly after that but only after a failed Soviet coup in 1992 could the transition of the entire region away from Soviet-dominated socialism be considered reasonably ensured Consequently, enterprise funds were a creative initial experiment in promoting foreign investment in the region The uncertainties were so great that private foreign investment was seen as unlikely until conditions were clarified

The first two funds do appear to have played a key catalytic role, and their initial operations preceded any substantial direct foreign investment In Poland, the fund provided 29 percent of total direct foreign investment during its first two years of operation In 1990 net foreign investment flows into the entire former Soviet bloc were $300 million, more than two thirds of it flowing into Czechoslovakia The Czech–Slovak fund was the first to operate in a country where direct foreign investment was already substantial (inflows of $464 million in 1989–90)

See Dale Adams "The Environment for Small Firms and Financial Markets in Eastern Europe and the Former Soviet Union USAID/CDIE March 1997

Like the Czech–Slovak fund, all of the later funds began investing subsequent to substantial direct foreign investment Table 3 summarizes the amount of direct foreign investment that had already taken place before the enterprise fund in each country undertook significant activity The comparison is stark In the first two fund countries, only $100 million of Western direct investment preceded activity by the fund In the more recent eight funds a total of $6 8 *billion* preceded their investments

Thus while the enterprise fund may have been the biggest game in town in Warsaw in 1990, capable of commanding the attention of the country's political leaders, none of the later funds had this luxury The favorable experience of the Polish fund may have contributed somewhat to the perception that the time was ripe for private investment in the region In any event, private capital inflows exploded after 1991 They reached more than $11 billion in 1996 and accumulated to more than $42 billion for the period 1991–96 Only in Poland did investments by an enterprise fund account for more than 4 percent of net direct foreign investment, most funds were in the neighborhood of 1 percent of such investment

Much of this investment flowed to major projects such as privatization of public utilities and large industrial firms, thus it does not compete directly with the orientation of the enterprise funds toward medium-size firms Neverthe-

Table 3 Enterprise Funds and Direct Foreign Investment

Fund	Authorized Capital for Investment ($ millions)	Date of First Investment by Enterprise Fund	DFI Before Significant Fund Activity ($ millions)[a]	Prior DFI inflow as % of Fund Resources ($ millions)	Fund Investments as % of all DFI, 1989–96
Polish	240	October 1990	100	42	5 6
Hungarian	60	October 1990	0	0	0 4
Czech–Slovak	60	October 1991	1,054	1,757	0 5
Bulgarian	50	August 1992	102	204	3 6
Russian	440	September 1994	1 575	358	1 1
Baltic	50	September 1995	788	1,576	0 5
Romanian	50	February 1996	969	1 938	0 6
Central Asian	150	March 1995	1 619	1,079	1 1
Western NIS	150	November 1995	914	609	1 3
Albanian	30	January 1996	178	593	1 0

Note South Africa is excluded because unlike the rest of the countries it did not undergo a transition from socialism

[a]Since foreign investment data are available only on an annual basis the comparisons cannot be exact The cutoff years for prior direct foreign investment flows were as follows 1990 for Polish and Hungarian 1991 for Czech–Slovak 1992 for Bulgarian 1993 for Russian 1994 for Baltic and Central Asian and 1995 for Romanian Western new independent states and Albanian Direct foreign investment data are from the European Bank for Reconstruction and Development

less, some other private investors have looked for opportunities in this area In addition international agencies notably the European Bank for Reconstruction and Development and the International Finance Corporation, have provided large amounts of both loan and equity funding for the region

Other investors' interest also had the effect of stiffening the competition for people with the appropriate country and financial expertise The funds had to compete with private firms offering compensation to the best professionals far in excess of the $150 000 ceiling on salary payment to fund employees Funds had the dual difficulty of hiring qualified people and holding onto people whose skills they had developed

The experience of the newer funds does demonstrate the commitment of all the funds to prudence in investment The U S government, beginning with the 1990 congressional report cited earlier has consistently pushed enterprise funds for a faster rate of disbursement To their credit, the boards of directors—with the exception of the Czech–Slovak Fund—have not responded to this encouragement by investing without due diligence Though the funds have made investment mistakes, they have shown care and concern for results in managing public resources

Profitability Of Enterprise Funds

Enterprise funds differ from more typical uses of U S foreign aid funds by offering the prospect of returning money to the Treasury once the fund has completed its work Although some USAID resources (usually for private-sector activity) are lent for long maturity and later repaid to the Treasury the great bulk of U S foreign assistance is in the form of grants Thus enterprise funds may offer a more cost-effective way to promote development There are two issues in this area 1) the amount of resources that enterprise funds are likely to have available at the time when the entity is dissolved and 2) the ultimate disposal of those resources

As of the end of 1998 none of the enterprise funds had a net worth equal to the value of the U S government funds it had received The Polish fund had shown a net gain in 1997, but a sharp decline in the Polish stock market following the Russian financial collapse cut the market value of its portfolio in 1998 The Hungarian fund also saw its portfolio decline in value in 1998 Both funds could well show a net gain in their portfolio by the time they are disbanded Of the other two early funds, the Czech–Slovak is likely to have lost most of the resources provided by the U S government, while (more speculatively) the Bulgarian fund is likely to show a smaller loss

Consequently, none of the early funds is likely to be profitable for the U S government in a financial sense Financial profitability would require that the portfolio grew by enough to pay the interest cost incurred by the U S Treasury for the resources provided to the enterprise funds Roughly that would mean that an enterprise fund operating for 10 years would have to show a nominal profit of about 40 percent

For the newer funds, it is too early to speculate about their ultimate profitability, but the performance of their investments so far gives no evidence that they will fare better than the early funds Indeed, the prospect is that they will do less well Most of the new funds have had far higher operating costs than the early funds That means they will have to earn a higher rate of return than the early funds on the resources actually invested

The second issue is the disposal of each fund's capital once it is disbanded This applies only to the first 10 funds The Southern Africa Enterprise Development Fund was created as a permanent entity Polish fund s resources are currently being debated within the U S government The Clinton administration has been considering allocating about half the proceeds into a foundation in Poland that would permanently promote private-sector development The other half would be returned to the Treasury Another proposal favored by some in Congress, would leave the entire proceeds in Poland Whatever the outcome, the decision in the Polish case is likely to set a precedent for the proceeds from the other funds

Prospects for the Future

As indicated earlier, it is still too early to judge the value of the existing enterprise funds Much of their impact is still to be determined As the funds become fully invested over the next 4 to 5 years much will be learned about their effectiveness and significance They have built up expertise in working in difficult country conditions experience that can be expected to pay off in a faster pace of investments in the future Judging by the commitment of fund managers to making the concept work, and the care that they have shown the managers are likely to succeed on average in building good portfolios of investments—unless country economic conditions deteriorate How this plays out in the individual cases, and the contribution it makes to the overall development of the country concerned will depend on the skill of the individual managers

The Problem of Incentives

Many fund principals have dedicated substantial time and effort to the success of their enterprises, and there is no indication that any of the funds have suffered through lack of attention Nevertheless, financial incentives are at the heart of market economies The investments that cause economic growth are made because the entrepreneurs undertaking them expect to be rewarded by profits if they succeed and penalized by losses if they do not Governments have usually failed as owners and managers of productive enterprises because they fail to provide incentives for profitable operation

Enterprise funds are unusual in seeking to create profitable companies while limiting the use of financial incentives They differ from the private sector financial tradition in two ways First, members of the funds boards of directors donate, gratis their time and expertise to the effort Second, some fund employees accept lower incomes than they could earn elsewhere The compensation limit of $150,000 a year is below that of private venture fund managers operating in these countries (though compensation in private venture funds is usually heavily dependent on profitability of the investments) Employees of the funds are expected to create wealth for others without the reward usually expected from success

The use of nonmonetary incentives by the U S government has a long and honorable tradition There has been no shortage of committed volunteers when the need for them was evident as during wartime or natural disasters Where a task is urgent and is connected to U S national purposes, it is likely to gain the interest of successful people

As tasks become less urgent and critical, though, the ability to attract the best people to an activity and to maintain a high level of commitment is likely to wane It will become more difficult to secure the best candidates for positions, and those who are appointed are likely to become less engaged Where enterprise funds stand in this respect is impossible to say Nevertheless it seems safe to say that "incentive misalignment" is not a proper long-run approach to any problem As a problem turns from critical to chronic from urgent to workaday, the incentive structure needs to change The U S government like others should be expected to pay for what it gets

Conclusions: Are More Enterprise Funds Needed?

The available evidence suggests that enterprise funds can work They can play a constructive role in promoting the development of the private sector by identifying and making prudent investments in medium-size companies and helping them grow Compared with the alternatives available in 1989 to encourage private sector development in those countries, the first enterprise funds were good investments, and the Polish fund exceeded any reasonable expectations More recently created funds have not lived up to the hope that they would play a transformative role in helping countries move to market economies In large part that is because of two factors First, the condition they were created to promote (the flow of private investment into former communist economies) is already happening Second, the institutional conditions for private sector dynamism are much less developed and are likely to emerge only gradually

Despite the difficulties encountered by newer enterprise funds, do they represent a better way than other alternatives to achieve the development goals that the U S government has established for its foreign aid activities? Enterprise funds cannot be compared with activities in other sectors, such as health and population, but they do seek the same broad goals as USAID activities in promotion of private sector development For many years, both USAID and other donors sought to provide financing to the private sector through lending programs through "development banks," which channeled donor resources into investment in business enterprises The development banks, usually government controlled, often invested in the wrong enterprises managed their portfolios poorly and became funnels for donor flows rather than intermediaries between savers and investors USAID no longer supports this approach, though some other donors still do and enterprise funds are clearly a better approach

In recent years USAID has experimented with a variety of other approaches These have included projects to encourage stock-market development, venture capital projects [†] banking reform, and other related activities Many of these projects are recent so the track record has not been established, although results on some of them are thought to be quite encouraging

In the 1960s and 1970s USAID relied mainly on host government agencies to implement its assistance programs, including those intended to promote the private sector In recent years and notably in dealing with the former Soviet bloc, the Agency has experimented with a variety of approaches in which it sets the broad goals but in which private firms manage the activity For example a recent USAID project to create an over-the-counter stock market in Romania used American financial firms to design the system Such hybrid approaches open up many possible combinations of U S government and private sector collaboration Promoting enterprise development is not simply a matter of choosing between enterprise funds and government-run activities but one of designing programs that best suit the problems being addressed

Enterprise funds were created in part because the world was stepping into the unknown, and flexibility was critical The ambiguous relationship between the funds and the U S government (with the latter providing the money but having no formal role on the funds' boards of directors) seemed a reasonable compromise at the time The available evidence suggests that the critical problems are now quite different The

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For a discussion of the problems USAID and other donors have had with this vehicle see Cressida McKean *Development Finance Institutions A Discussion of Donor Experience* USAID/CDIE July 1990

[†] For a discussion of USAID s disappointing experience with direct promotion of capital markets see James Fox *The Venture Capital Mirage* USAID/CDIE 1996

issue is not one of encouraging private investment flows to transition economies Rather it is one of ensuring policy environments that will continue to encourage flows into productive activities And it is an issue of creating the wide range of institutions, such as legal and regulatory necessary to providing a clear set of rules of the game for private entrepreneurial activity

In sum, the available evidence suggests that enterprise funds are best suited to situations in which two conditions exist First the government must be strongly committed to private sector development and to market economics Second, there must be a substantial number of investment opportunities where infusions of capital and technical assistance can produce quick results These results will then reinforce the government's commitment to the policies it has instituted Poland, Hungary and Czechoslovakia in 1989 came much closer to meeting these criteria than did the countries in which enterprise funds were established later

In countries in the developing world, the first condition will be met more frequently than the second In most developing countries, private sector development is likely to be a slower process where institutions and attitudes of government officials and the public will evolve only gradually Where slower change is likely the use of public funds to finance the expansion of a few individual enterprises also becomes questionable In such cases, the U S government should look for more narrowly directed activities more closely linked to immediate problems, but that help lay the basis for dynamic growth of the private sector

Appendix

USAID-Supported Enterprise Funds: Case Summaries

The following text summarizes the experience of the 11 enterprise funds established with USAID funding since 1990 They capsulate more detailed case histories that have been prepared on each of the funds The funds have an authorized total funding of $1 4 billion The funds were initially established as independent of USAID and generally free to set their own approaches and implementation mechanisms (An early congressional appropriations report states that USAID's only responsibility was to 'write a check when the funds say they need it ") The funds have gradually come under increasing management oversight by USAID The success of the funds has varied widely, as the case studies indicate

1 Polish–American Enterprise Fund

The Polish–American Enterprise Fund has been operating since 1990, capitalized by a grant from USAID with an authorized total funding of $256 million The fund seeks to promote development of the Polish private sector through a combination of equity investment in medium-size and small Polish firms, strategic investments in financial enterprises, lending for smaller businesses and technical assistance Its approach has been to build up a Polish professional staff in a core institution and to create a series of other self-sustaining entities including a mortgage bank and a commercial bank specializing in small loans The fund has maintained this general approach consistently over time

The fund was a highly visible presence in Poland particularly during the period 1991–93 before significant private foreign investment began to flow into the country Its board included members of the U S financial community but also former national security adviser Zbigniew Brzezinski and AFL–CIO president Lane Kirkland, both of whom had been active for more than a decade in promoting Poland's separation from the Soviet bloc Polish members of the board were major figures including a subsequent prime minister and a former finance minister

The Polish–American Enterprise Fund is the most successful of the USAID-financed enterprise funds The fund has raised $100 million in capital from other sources in 1992 for joint private enterprise investment, and it closed on a second fund, of $162 million in 1997 Its small-

These summaries were drawn from the longer case studies of each of the funds written by Zan Northrip Ellen Peterson and James Fox lending program identified an important niche (loans of $20,000 to $75,000) not being served by existing institutions and demonstrated how financial services could profitably be provided to this segment of the market Later it established a program for even smaller loans to test whether this market segment could also be reached profitably A mortgage bank played a pioneering role in mortgage finance and helped improve the institutional environment for mortgage-based housing finance It was sold to General Electric Credit for a small profit in 1998 On the whole, the fund has approximately broken even, with assets at the end of 1998 about equal to the value of the U S government grant *

In May 1996 the fund saw its mandate as nearly fulfilled It began discussions with the U S government for an orderly termination The fund is expected to sell its assets and end operations by 2001 In 1997, the administration proposed to return about $155 million to the U S Treasury, with the remaining assets (then estimated at $125 million) to be transferred to a permanent foundation to promote Polish development Ambiguities in the original concept for enterprise funds have made this controversial, and some have proposed that all of the proceeds from the fund's dissolution remain in Poland Congressional action will determine the ultimate outcome

In sum the fund has played an important role in Poland's transition to a market economy Alone among the enterprise funds, its performance has clearly exceeded the expectations of the U S government in establishing it

*The fund had shown a net gain through 1987 but a sharp decline in Polish stock prices in 1988 in the wake of financial difficulties in other emerging markets reduced its valuation by about $30 million Valuations could rise by the time that the assets are sold Nevertheless, it seems unlikely that the fund will be profitable to the U S government in financial terms (including the cost to the U S Treasury of interest on the intial grant) To break even in these terms the funs would have to produce an increase in value by $100 million

2 Hungarian–American Enterprise Fund

The Hungarian–American Enterprise Fund was created in 1990, at the same time as the Polish–American Enterprise Fund It has made mainly equity investments in 40 enterprises in Hungary From its inception, the fund's primary purpose has been to promote development of the Hungarian private sector through equity investment in privately held companies which would be divested as their operations matured Its approach has been to build up a Hungarian professional staff that could manage the fund's investments and raise additional private money

The fund began making investments quickly and appeared to be on track to full disbursement by the end of 1993 However, its activities were in effect, suspended for nearly a year in 1993 because of a major conflict with the U S government The fund established a merchant banking subsidiary in 1992 as a means of promoting investment in Hungary When details of financial commitments to the merchant banking principals became public in 1993 Congress held up further U S disbursements The fund's management was eventually changed, and the fund later resumed operations The new management restored good relations with the U S government though the suspension of operations was costly to the fund's effectiveness

The fund operated in a relatively favorable country environment with transformation of the economy from communism occurring rapidly and successfully Broadly, the Hungarian economy evolved as the fund had expected By September 1998 the fund was almost entirely a Hungary-based operation and was in the process of privatizing its management staff as a step toward dissolution of the fund

The Hungarian–American Enterprise Fund had an investment portfolio of 22 firms in 1998, having divested itself of 25 firms from earlier investments In 1997, the fund succeeded in establishing a private equity fund of $30 million The fund's portfolio was valued in September 1998 at $24 million compared with a cost basis of $37 million The fund had shown a modest rise from cost a year earlier, but a stockmarket decline in 1998 following the Russian financial crisis sharply reduced the value of its traded companies Altogether, the Hungarian–American Enterprise Fund s assets were valued, probably conservatively, at $29 million in 1998 compared with USAID disbursements of $52 million for nontechnical assistance activities

3 Czech-Slovak–American Enterprise Fund

The Czech-Slovak–American Enterprise Fund has been in operation since 1991 making mainly equity investments in about 50 enterprises in the Czech and Slovak Republics From its inception, the fund's primary purpose has been to promote development of the private sector through a combination of equity investment and lending in small and medium-size enterprises The fund sought to make profitable investments, but it also attempted to promote investment in smaller towns, export industries, and joint ventures with U S businesses In early years, it relied heavily on expatriate staff including the MBA Enterprise Corps and International Executive Service Corps, to serve as its investment officers, thus it did not build up a local professional staff Like the other early enterprise funds, this fund has sought to increase its impact by attracting private money, but without success

The fund has operated in relatively favorable country environments, though the division of Czechoslovakia into two separate republics in 1993 did cause some dislocations in economic activity The fund from the outset maintained separate offices in Prague and Bratislava, so it was not seriously affected The transformation of the two economies from communism was occurring rapidly and successfully, though more so for the Czech Republic However the fund has fared poorly, with many investments proving unsatisfactory At the end of 1996, the Czech operation was disbanded, and the investments of this part of the fund sold to a private investor at a loss of 90 percent of original cost

The major factors in the fund's poor performance are thought to be excessive centralization of decision-making in the fund's board of directors, lack of effective oversight of investments, and rapid staff turnover particularly in Prague The Slovak office has also experienced substantial, though smaller, write-downs of its investments A small-scale scandal in 1995 led to the replacement of the chairman of the board the entire board of directors later resigned At the direction of the U S government, two new boards of directors were created in 1996 an interim board which took over in May 1996 to restructure the portfolio, and a new permanent board, which began to operate in October 1996

The new board spent most of its efforts during its first two years working out or disposing of problem investments that it inherited Few new investments were made As of September 1997 the 27 investments held by the fund were valued at $2 1 million, compared with a cost basis of $9 8 million All together, the fund valued its net assets at $12 6 million representing the carrying value of the $46 2 million received from the U S government

The Czech-Slovak–American Enterprise Fund experience was a watershed in U S government relations with these entities, with profound consequences for subsequent U S government oversight The portfolio losses showed that things could go very wrong for enterprise funds demonstrating that oversight could not be left only to the fund's board of directors These difficulties led the U S government to replace the entire board This action, not contemplated in grant agreements or corporate charters, cleared up ambiguities about the relationship between the U S government and enterprise funds Enterprise funds are creations of the U S government which showed itself to be prepared to redirect a fund s activities or to demand the resignation of its board of directors

4 Bulgarian–American Enterprise Fund

Like the Bulgarian economy itself, the pace and performance of investments made by the Bulgarian–American Enterprise Fund were a frequent disappointment Five years after its formation, the fund had placed less than $20 million of its $55 million in authorized capital It had several early losses, and the value of the fund's portfolio at the end of 1996 was estimated (probably conservatively) at two thirds of its initial worth While the fund has realized significant achievements in providing small-business and microcredit loans, those programs had to be curtailed in 1996 to rein in delinquencies rising in the wake of a new Bulgarian economic crisis

A tenet of the enterprise fund model is the flexibility of fund directors and management to alter their products in response to market circumstances The fund made major changes to its offerings in 1994 when it shifted from an emphasis on large equity placements to one that targeted micro and small borrowers Three years later the fund returned to an emphasis on larger investments Buoyed by both an improvement in the Bulgarian policy regime and the earlier collapse of much of the country's financial system the fund sharply increased its investments in 1997 and 1998 and appears likely to be fully invested by the end of 1999

Bulgaria provided the enterprise fund model with challenges more daunting than those encountered in Poland or Hungary The U S government has consistently pushed the fund to invest at a faster rate than the fund found prudent It is an open question—particularly given the economic crisis of 1996–97—whether faster disbursement would have been desirable Should the economic recovery begun in 1997 prove sustainable, the fund s caution during earlier years will prove justified

5 U S –Russian Investment Fund

The U S –Russian Investment Fund was formed in May 1995 through the merger of two existing enterprise funds The Russian–American Enterprise Fund, with an authorized capital of $340 million and the Fund for Large Enterprise Restructuring, with an authorized capital of $100 million, had been established in September 1993 and February 1994 respectively to promote the development of viable private enterprises in Russia Although both funds operated in Russia, each had been created to serve a distinct financial market—the Russian–American Enterprise Fund for small and medium enterprises and the Fund for Large Enterprise Restructuring for large nondefense enterprises Both initially emphasized investment in equity

The early experience of the Fund for Large Enterprise Restructuring was seen as more positive than that of the Russian–American Enterprise Fund The former had committed more than $30 million, or 30 percent of its authorized capital in its first 15 months following incorporation The Russian–American Enterprise Fund, by contrast, had barely begun to make commitments though it had built up a large staff and had opened offices in six cities The high operating costs of maintaining two funds, and the slow pace of investment by the Russian–American Enterprise Fund, along with conflict within its board of directors, led to the decision by the U S government to merge to two funds The chairman and the chief executive officer of the Fund for Large Enterprise Restructuring assumed the same positions in the merged fund

Replacing the original funds with the U S –Russian Investment Fund allowed a significant reduction in staffing and other administrative costs The rate of investment in 1996 however was seen by USAID as disappointingly slow The uncertainties related to national elections may have contributed to this The pace of investment increased somewhat in 1997 and further in 1998, but the fund's accumulated disbursements for investments by September 1998 had reached only 28% of its capital By assuming the responsibilities of both of its predecessors the fund took on the broadest most complex mandate in the U S government s enterprise fund program With $440 million in authorized capital, it is also the largest of the enterprise funds

6 Baltic–American Enterprise Fund

The Baltic–American Enterprise Fund was established in 1994, drawing on a grant from USAID with an authorized total funding of $50 million The fund seeks to promote development of a standardized lending vehicle for small business in the three Baltic countries (Latvia, Lithuania and Estonia) Average loan size was targeted to be about $100,000 The fund concluded that its small capital and its three-country mandate made loans preferable to equity investment The fund also sought to diversify its investment activity among economic sectors, to promote activity outside the capital cities, and to distribute its operations "equitably" among the three countries Operationally it established offices in each It hired core staff for these offices but used subcontracting extensively for administration logistics, and training

The fund in 1997 began to broaden its approach beyond its initial standardized loans by offering mortgage loans and seeking occasional equity investments By September 1998 after slightly more than four years of operation, the fund had made more than $25 million in investments Its portfolio performance was considered to be quite satisfactory, with only small arrears on its outstanding loans

7 Romanian–American Enterprise Fund

The Romanian–American Enterprise Fund incorporated in July 1994 was capitalized with a $50 million grant from the U S government The fund has had wide latitude in setting a course of action and developing a range of financial products that would meet its dual commercial and development goals

The fund established explicit division between "revenue generating" and "development" activities The latter include three programs providing small or micro loans About $5 million has so far been committed for these programs

The revenue-generating activities are embodied in its major investment program, which makes investments in the $500,000–$5 million range The fund has invested about $28 million for this purpose In 1997 the fund sold half of its major investment portfolio to a private group, which also agreed to coinvest in all future Romanian–American Enterprise Fund projects The fund hopes to bring up to $50 million in private money under its management

The fund has had to deal both with difficult internal and external environments Prior to the probusiness presidential and parliamentary elections of November 1996, economic and political progress in Romania was halting and marked by significant reversals Almost since its inception, the fund has been beset by a number of board and management problems three of the fund's board members have resigned in protest and the board chairman was voted out By early 1997, a new president of the fund and a new chairman of the board were in place and management stability had been restored

8 Central Asian–America Enterprise Fund

The Central Asian–American Enterprise Fund was established as a nonprofit corporation in July 1994 Its purpose was to encourage the transition to market economies in five republics of the former USSR—Kazakhstan, Kyrgyzstan Tajikistan, Turkmenistan and Uzbekistan—by promoting development of viable private businesses The fund was established with an authorized capital of $150 million

The fund identified its role as providing a combination of debt and equity to small and medium enterprises that offered prospects for substantial growth and profitability The fund moved quickly to develop a portfolio of investments By September 1998 it had disbursed $77 million It was the fastest of any of the newer funds in committing capital during its first three years of operation though its performance in this regard has lagged substantially behind the initial funds Besides its investment portfolio, the fund established a subsidiary to make smaller loans (typically of $10 000 to $100 000) through participating commercial banks in the republics About $12 million was lent under this program through 1998

The fund has encountered major differences in the country environment in the five republics It established representative offices in each and has lent substantial amounts in each country Kazakhstan has received the largest share (33 percent), and Kyrgyzstan the least (8 percent) The Uzbek government's 1996 move to end the convertibility of the currency led the fund to plan to curtail activity there The fund has explored the possibility of raising additional capital from other sources to supplement its U S government grant, but this had produced no results by the end of 1998 In 1998, the fund began to experience serious problems with its portfolio realizing a loss of $5 million from investments and currency depreciation It substantially raised the provision against losses in its investment portfolio

9 Western NIS Enterprise Fund

The Western NIS Enterprise Fund was organized in August 1994 with an authorized capital of $150 million The fund's mandate covers three countries—Ukraine Moldova, and Belarus—and the fund has opened offices in each The political and economic climate in Belarus has been quite unfavorable, and Moldova offers only limited opportunities, so the fund has concentrated its efforts in Ukraine The fund's programs include its direct investment program (which had invested in 16 firms in Ukraine and 2 in Moldova by September 1998) and a $5 million small-lending program operating through four offices in Ukraine By September 1998, the fund had invested $48 million and considered its portfolio to be performing satisfactorily

10 Albanian–American Enterprise Fund

The U S government first expressed willingness to establish an enterprise fund for Albania in May 1992 Doubts about the feasibility of such a fund in this small economy slowed forward movement, but a formal commitment was made in January 1994 It was only 13 months later in February 1995, that the Albanian–American Enterprise Fund was legally established, with an authorized capital of $30 million through a grant from USAID This gives it the smallest capital of any enterprise fund The fund's purpose was identified as promoting the expansion of small and medium-size enterprises in Albania through both its investment activity and encouragement of economic policies more favorable to development of the private sector

The fund s core activities have been making both equity investments and loans Through the end of fiscal year 1998 the fund had disbursed $2 million in 10 investments Though the fund expressed a preference for equity investment, 60 percent of the portfolio was in loans The fund also has sought to establish a commercial banking subsidiary and requested USAID approval in early 1997

The Albanian country environment has presented major difficulties for the fund In 1997 the collapse of several financial pyramid schemes sparked several months of anarchy In 1998 the U S government responded to threats of terrorism by closing its embassy and requiring all U S – supported organizations, including the fund, to evacuate the country Despite these difficulties, the fund had made commitments of $22 million on some 30 investments, including the purchase of a commercial bank Notwithstanding the political environment the fund regarded the performance of its investment portfolio as generally satisfactory

11 Southern Africa Enterprise Development Fund

The Southern Africa Enterprise Development Fund was created in February 1995 to provide equity and debt capital to enterprises in 11 southern African countries It was the first enterprise fund to be created outside the former Soviet bloc and was established with an authorized grant of $108 million from the U S government

The fund's backers also hoped to innovate on the existing enterprise fund model, taking advantage of lessons learned from the European funds Among the improvements sought by the fund's creators were a strengthening and formalization of relations between the fund and the U S government a clarification of fund objectives, a clearer strategy for fund evolution and maturity and a structure of monetary incentives for fund managers These goals were partially achieved Alone among the enterprise funds, a USAID employee participates as a nonvoting member of the board of directors

The fund's structural improvements were accompanied by greater restrictions on fund placements The fund does not enjoy the "notwithstanding" authority granted to the European funds and is therefore subject to a range of U S regulations and procedural requirements from which the other funds are exempt, such as a prohibition on investment in southern African industries potentially competitive with American producers The restrictions make the achieving fund sustainability more difficult and give the fund less flexibility in demonstrating profitable investments to outside capital

Clarity of intent (which is lacking in much of the U S enterprise fund program, but better established in the basic documents of the fund) has not yet borne fruit in the fund's operations A very large board of directors has apparently been split on approaches to implementation and the selection of top management was delayed by these differences It took the fund more than two years to make its first disbursement By September 1998 it had disbursed $8 2 million in investments in 13 enterprises